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IN THE

Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of the Supreme Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of Petitioners, the Boeing Company and its subsidiaries.[1] Tax Executives Institute ("TEI" or "the Institute") is a voluntary, nonprofit association

[1] Pursuant to Rule 37.6, *amicus* TEI states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, its members' companies, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Tax Executives Institute has received the written consents of Petitioners and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and has approximately 5,300 members who represent more than 2,800 of the leading businesses in the United States, Canada, and Europe. The members of the Institute represent a cross-section of the business community in North America. The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws and to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers.

Members of the Institute have a vital interest in this case, which involves the resolution of a sharp conflict concerning the interpretation of tax statutes affecting the foreign commerce of the United States. The substantive issue in the case is whether Treas. Reg. § 1.861-8(e)(3) (relating to the allocation of research and development expenses) is valid when its application frustrates the operation of the domestic international sales corporation (DISC) and foreign sales corporation (FSC) provisions of the Internal Revenue Code. Eight years ago, the U.S. Court of Appeals for the Eighth Circuit held in *St. Jude Medical, Inc. v. Commissioner*, 34 F. 3d 1394 (1994), that the Treasury Regulation is invalid in this context, noting that the mandated allocation method is inconsistent with Congress's intent to allocate costs to definitely related gross receipts. In the instant case, the U.S. Court of Appeals for the Ninth Circuit declined to follow *St. Jude Medical* and held instead that the regulation is valid. *Amicus* TEI submits that the Ninth Circuit's decision is wrong because it misapprehends the DISC and FSC statutory schemes and permits Treas. Reg. § 1.861-8(e)(3) not only to override the statute but also to undermine congressional intent.

This case has significant ramifications for taxpayers other than Boeing. The resolution of the question presented in this

case affects the tax liabilities of thousands of other businesses that are also subject to these provisions. As individuals who must contend daily with the interpretation and administration of the nation's tax laws, the Institute's members have a vital interest in the proper disposition of this case.

SUMMARY OF ARGUMENT

1. For more than three decades, the domestic international sales corporation (DISC) and foreign sales corporation (FSC) provisions of the Internal Revenue Code have provided much needed tax relief for U.S. companies competing in foreign markets. Because of the similarity between the provisions, *amicus* TEI will focus primarily on the rules applicable to DISCs.

This case involves how Boeing's research and development (R&D) expenses should be allocated to the revenues generated by its export sales of commercial aircraft for purposes of determining its allowable benefits under the DISC and FSC provisions. The issue arises because Treas. Reg. § 1.861-8(e)(3) *requires* taxpayers to allocate R&D expenditures according to the two-digit Standard Industrial Classification (SIC) Manual produced by the Office of Management and Budget. The DISC regulations, however, allow taxpayers greater flexibility, permitting them to group transactions along product lines.

In determining its combined taxable income (CTI) during 1979 through 1987, Boeing exercised its right to elect product groupings under the DISC and FSC regulations, grouped its export sales by airplane program, and determined its costs, including R&D costs, for each airplane program. Under the DISC regulations, Boeing's determination properly allocated definitely related expenses to its export sales and was also consistent with the general rule of Treas. Reg. § 1.861-8(a)(2), which provides that "allocations and apportionments are made on the basis of the factual relationship of deductions to gross income."

The government disagreed with Boeing's approach, not on the grounds that it had failed to establish a direct link to support its allocation, but rather on the grounds that Treas. Reg. § 1.861-8(e)(3) applies certain mechanical rules for allocating R&D expenses. Although the district court held that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to the CTI calculation, the Ninth Circuit concluded that in computing the company's net income, the Commissioner "properly applied Treas. Reg. § 1.861-8(e)(3) to allocate Boeing's R&D costs to its export sales." App. at 2a.[2] The court's conclusion is wrong as a matter of law.

Amicus TEI submits that Treas Reg. § 1.861-8(e)(3)'s requirement that a taxpayer allocate R&D expenses to sales revenues within a single two-digit SIC code vitiates the flexibility taxpayers have under the DISC statute to claim congressionally provided tax benefits. The section 861 regulations were tailored for the purpose of allocating and apportioning income and expenses between foreign and domestic sources under the foreign tax credit provisions of the Code. The mechanical rules of Treas. Reg. § 1.861-8(e)(3) impermissibly conflict with the more specific DISC regulations, which accord taxpayers a choice in grouping sales according to product lines. Because Treas. Reg. § 1.861-8(e)(3) cannot be harmonized with the purposes of the DISC provisions, it is invalid as applied to DISCs.

2. Congress enacted the DISC and FSC provisions to provide a more level playing field for U.S. companies competing in foreign markets. The DISC provisions were enacted at a time when the economy was doing poorly. The Nixon Administration determined that tax changes were needed as part of a balanced program of stimulation and

[2] References to "App." are to the appendix filed with Boeing's Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, No. 01-1209 (Feb. 15, 2002).

stability. The changes were designed not only to stimulate spending but also to provide more jobs in the United States. Congress agreed, stressing the importance of providing tax incentives for U.S. firms to increase their international business not only because of their stimulative effect, but also to remove a disadvantage to U.S. businesses engaged in export activities through domestic subsidiaries. The Revenue Act of 1971 contained the DISC provisions, which were intended to provide a broad incentive program for taxpayers.

In establishing the DISC regime, Congress created a statutory scheme that was clearly intended to permit DISCs to earn profits in excess of those earned under the arm's-length pricing rules otherwise used between related parties. Thus, Congress established a unique regime under which taxpayers using DISCs were to obtain benefits not ordinarily then available.

3. There are two primary reasons why Treas. Reg. § 1.861-8(e)(3) should not be applied to the calculation of CTI. First, Congress intended only that the *general* principles of section 861 should apply in the DISC context. Second, the special allocation rule of Treas. Reg. § 1.861-8(e)(3) does not further those principles in this context.

A. Computing CTI requires allocating costs to gross receipts and, in the first instance, requires allocating costs to the gross receipts to which they definitely relate. If costs are not definitely related to certain receipts, they are apportioned among income on a ratable basis. Congress provided that these allocations and apportionments are to be "*determined in a manner consistent with* the rules set forth in § 1.861-8." The DISC regulation—Treas. Reg. § 1.994-1(c)(6)(iii)—implements this legislative history by providing that CTI should be determined "*generally in accordance with the principles applicable under section 861*."

What is abundantly clear is that the regulation implementing the DISC provisions and governing the allocation of costs for CTI purposes, as well as the legislative history of the DISC provisions, express respect for the section 861 principles, but go no further. The DISC rules contemplate "consistency." The legislative history contemplates applying generally the "principles" of section 861. In each case, the goal of the statute is to determine CTI so that actual circumstances are reflected. The government's attempt to rigidly apply rules crafted under section 861 for another purpose is unsupportable and distortive.

The Code's sourcing rules "undertake to classify the sources of income within the United States by the nature and location of the activities of the taxpayer or his property which produces income." *Commissioner v. Ferro-Enamel Corp.*, 134 F.2d 564, 566 (6th Cir. 1943). The rules have been a part of the tax law almost since the beginning of the modern income tax. Treas. Reg. § 1.861-8 provides some general and some mechanical guidance for allocating and apportioning deductions. From a general perspective—consistent with the DISC regulations—there must be a factual relationship between the deduction and the class of gross income. Treas. Reg. §§ 1.861-8(a)(2),-8(b)(2). If a deduction cannot be identified with any specific class of gross income, it will generally be apportioned among all of the taxpayer's gross income under Treas. Reg. § 1.861-8(b)(5). Boeing's allocations were consistent with these general rules.

That the DISC legislative history and regulations incorporate consistency with the general section 861 principles into the CTI calculation does not mean that the statute requires the mechanical application of Treas. Reg. § 1.861-8(e)(3) or provides support for its validity in these circumstances. "Consistent" means "compatible"; it does not mean "identical." *See Webster's Ninth New Collegiate Dictionary* 280 (1988). Indeed, it would be serendipitous if

the rules crafted for determining income source could be applied, without modification, to implement the DISC regime with equally important but different policy objectives.

In this case, the cross-references to the principles of section 861 in the DISC regulation and legislative history are not authority to apply all the mechanical rules of the section 861 regulations for purposes of allocating costs, without regard to factual relationships, to sales in determining CTI. The objective of the DISC statute—to allocate costs in accordance with some factual relationship—may not be foreclosed, as the government would do in this case.

B. Under the general section 861 rules, a factual relationship between income and expense is a key element of allocation and apportionment. These are the "principles applicable under section 861" to which Congress referred in 1971 and which the DISC statute contemplates will be applied in determining CTI—a factual connection between income and expense is clearly required.

In contrast, the special rules for allocating R&D expenses set forth in Treas. Reg. § 1.861-8(e)(3) are mechanical rules that apply *in lieu of the general section 861 principles* in allocating R&D expenses. Rather than identifying a class of income to which the R&D expenditures actually relate, Treas. Reg. § 1.861-8(e)(3) generally assigns the expenditures to income related to a broad product category, which is limited to a list determined by two-digit SIC codes. The special allocation of R&D expenses may be appropriate in the context of the computation of the foreign tax credit, but it clearly undermines congressional intent in respect of the computation of CTI. Indeed, the consistency contemplated by Congress and Treas. Reg. § 1.994-1(c)(6)(iii) comes only by applying the general rules of the regulations under section 861 to establish definite factual relationships, not by departing from those relationships by applying mechanical rules for allocating R&D expenses.

It is consistent with the section 861 principles for the allocation of R&D expenses to yield to the DISC and FSC rules. By mandating the use of a special allocation rule for R&D expenses in respect of DISCs, the Treasury Department does violence to the statutory scheme. Treas. Reg. § 1.861-8(e)(3) is invalid as applied by the government to the computation of CTI.

ARGUMENT

I. THE NINTH CIRCUIT'S DECISION IS WRONG AS A MATTER OF LAW.

For more than three decades, the domestic international sales corporation (DISC) and foreign sales corporation (FSC) provisions of the Internal Revenue Code have provided much needed tax relief for U.S. companies competing in foreign markets.[3] In 1971, deficits in the United States' balance of trade led to the enactment of the DISC provisions. *See* Revenue Act of 1971, § 501, Pub. L. No. 92-178, 85 Stat. 497 (1971); *L&F Int'l Sales Corp. v. United States*, 912 F.2d 377, 377 (9th Cir. 1990).[4] Following a challenge under the General Agreement on Tariffs and Trade, Congress replaced the regime in 1984 with the FSC provisions. Deficit Reduction Act of 1984, § 801(a), Pub. L. No. 98-369, 98 Stat.

[3] Unless otherwise noted, references to the "Code" or "I.R.C." are to the Internal Revenue Code of 1954 and 1986 (26 U.S.C.), in effect during the years at issue in this case.

[4] A corporation qualifying as a DISC is permitted to earn a commission or profit on export sales that is not subject to immediate taxation. The DISC's parent corporation is taxed on a specified portion of the DISC income as a "deemed" distribution; the remaining income is tax-deferred until distributed to the parent or the corporation ceases to qualify as a DISC. The size of commission (or amount of profit) that the DISC may earn is determined according to one of three pricing methods provided by statute. I.R.C. §§ 991-97.

494 (1984).[5] Although there are technical differences between the two statutes, the FSC provisions retain many features in common with the predecessor DISC statute, including the features at issue here; the principal objective of these provisions is to address the inequities that arise when U.S.-based companies compete in foreign markets because of fundamental differences between the U.S. system of taxation and those of many other countries. The legislation provides a more level playing field for these companies. For more than 30 years, these provisions have served their purpose.

The issue in this case involves how Boeing's research and development (R&D) expenses should be allocated to the revenues generated by its export sales of commercial aircraft for purposes of determining its income from those sales and consequently its allowable benefits under the DISC and FSC provisions of the Internal Revenue Code.[6]

To determine taxpayers' maximum DISC benefit, Congress provided three methods for allocating the income:

> In the case of a sale of export property to a DISC by a [related] person . . . , the taxable income of such DISC

[5] A FSC is generally not subject to taxation on its "exempt foreign trade income," which is treated as foreign source income not effectively connected with the conduct of a U.S. trade or business. Again, the benefit is determined according to one of three alternative pricing methods. I.R.C. §§ 921-27. After the enactment of the FSC provisions, a modified version of the DISC statute remained in effect. I.R.C. § 995. In 2000, because of a trade dispute over the validity of the FSC regime, Congress repealed the FSC provisions and enacted the extraterritorial income (ETI) provisions. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000), *codified at* I.R.C. §§ 114, 941-43.

[6] Given the reliance of the FSC regulations on their predecessor DISC rules, this brief follows the lead of the Ninth Circuit in discussing primarily the DISC provisions of the Code. App. at 6a n.3. *See also* Stip. ¶ 28 ("Although there are some differences between the DISC and FSC rules, none of them relate to th[e] issue in this case.").

and such [related] person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (*regardless of the sales price actually charged*) in an amount which does not exceed the *greatest* of—

(1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,

(2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

I.R.C.§ 994(a) (emphasis added); *see* App. at 27a. The taxpayer may "choose the method resulting in the greatest amount of profit." *St. Jude Medical, Inc. v. Commissioner*, 34 F. 3d 1394, 1397 (8th Cir. 1994).

Pursuant to the latitude provided by Congress, Boeing elected to use the combined taxable income (CTI) method for calculating the amount of benefit to which it was entitled under the DISC provisions. Treas. Reg. § 1.994-1(c)(6) defines CTI as the excess of the DISC's gross receipts from the sale of export property over the total costs of the DISC and its supplier that relate to those gross receipts. In general, a higher CTI from a transaction will result in a larger benefit. In calculating CTI on export sales, revenues from sales must be determined as well as the costs and expenses properly allocable to those sales. Treas. Reg. § 1.994-1(c)(6)(iii) requires that a taxpayer allocate to revenues from export sales

"(a) the expenses, losses, and other deductions *definitely related*, and therefore allocated and apportioned, thereto," and (b) a ratable part of any other expenses, losses, or other deductions "determined *in a manner consistent with* the rules set forth in [Treas. Reg.] § 1.861-8." (Emphasis added.) This regulation implements the statutory directive to compute CTI on export sales and mirrors the legislative history of the DISC provisions. That history states that income shall be determined "*generally in accordance with the principles* applicable under section 861." H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 74 (1971) (hereinafter cited as the "1971 House Report")(emphasis added); S. Rep. No. 92-437, 92d Cong., 1st Sess. 107 (1971) (hereinafter cited as the "1971 Senate Report") (emphasis added).

The DISC regulations specifically permit taxpayers to group their transactions. Under Treas. Reg. § 1.994-1(c)(7), the pricing of goods sold by a taxpayer to its DISC is made on a transaction-by-transaction basis, but the taxpayer may annually elect to group the transactions according to product lines. The only limitation placed on the use of the administrative pricing methods is that the amount of taxable income that a supplier may shift to the DISC may not exceed 100 percent of the supplier's income generated by the transaction. Treas. Reg. § 1.994-1(e)(1)(i).

The issue in this case arises because Treas. Reg. § 1.861-8(e)(3)—which was added to the regulations after the enactment of the DISC provisions—*requires* taxpayers to mechanically allocate R&D expenditures according to the two-digit Standard Industrial Classification (SIC) Manual produced by the Office of Management and Budget. The DISC CTI calculation, however, contemplates allocating revenues from particular sales and, where grouping of products is elected, to particular products. In determining its CTI in this case, Boeing exercised its right to elect product groupings under the DISC regulations, grouped its export

sales by airplane program, and determined its costs, including R&D costs, for each airplane program. The company calculated its CTI on airplane sales net of the costs so determined. Under the DISC regulations, Boeing's determination properly allocated definitely related expenses to its export sales and was also consistent with the general rule of Treas. Reg. § 1.861-8(a)(2), which provides that "allocations and apportionments are made on the basis of the factual relationship of deductions to gross income."

The government disagreed with Boeing's approach, not on the grounds that it had failed to establish a direct link to support its allocations, but rather on the grounds that Treas. Reg. § 1.861-8(e)(3) requires that certain mechanical rules for allocating R&D expenses be directly applied to DISC. Application of those rules increased the R&D expenses allocable to Boeing's export sales, decreased CTI, and thereby reduced Boeing's DISC benefit.

In upholding Boeing's CTI calculation, the district court turned to the Eighth Circuit's decision in *St. Jude Medical*, 34 F. 3d at 1401, which held that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to the CTI calculation. Finding the Eighth Circuit's reasoning and analysis "persuasive and applicable to the current case," the district court found that there were serious defects in applying Treas. Reg. § 1.861-8(e)(3) to the computation of CTI that were "fatal" to the validity of the regulation. App. at 18a-19a, 23a. On appeal, the Ninth Circuit reversed, holding that Treas. Reg. § 1.861-8(e)(3) as applied to the CTI calculation is a permissible interpretation of the statute. App. at 2a.

Amicus TEI submits that the requirement of Treas. Reg. § 1.861-8(e)(3) that a taxpayer must allocate R&D expenses to sales revenues within a single two-digit SIC code vitiates the flexibility taxpayers have under the DISC statute to maximize tax benefits. The section 861 regulations were tailored for the purpose of allocating and apportioning income

and expenses between foreign and domestic sources under the foreign tax credit provisions of the Code. When applied to CTI calculations, however, Treas. Reg. § 1.861-8(e)(3) conflicts with another statute of equal importance and fails to achieve the DISC statutory goal of determining CTI based on the factual relationships between revenues and costs. In this context, the mechanical rules of that regulation impermissibly conflict with the more specific DISC regulations, which allow taxpayers a choice in grouping sales according to product lines. Because Treas. Reg. § 1.861-8(e)(3) cannot be harmonized with the purposes of the DISC provisions, it is invalid as applied to DISCs.

II. THE DISC PROVISIONS WERE INTENDED TO PROVIDE A MORE LEVEL PLAYING FIELD.

Congress enacted the DISC and FSC provisions to provide a more level playing field for U.S. companies competing in foreign markets. The DISC provisions were enacted at a time when the economy was doing poorly. The United States was experiencing high unemployment, a low gross domestic product, little or no growth in capital goods expenditures, and a rising inflation rate. Wage and price controls had been imposed and there was growing concern about the trade imbalance between the United States and other countries. 1971 House Report at 1, 3-4; 1971 Senate Report at 1-2, 6. The Nixon Administration determined that tax changes were needed as part of a balanced program of stimulation and stability. The changes were designed not only to stimulate spending but also to provide more jobs in the United States. *See* The White House, *Explanatory Material on the President's Economic Program* (Aug. 15, 1971), *reprinted in* BNA SPECIAL REPORT, App. C at C-2 (Aug. 16, 1971). It was against this background that Congress enacted the Revenue Act of 1971.

In the Administration's view, the DISC measure would "provide a substantial stimulus to United States producers to increase their export sales with resulting favorable effects on our balance of payments. This will create additional jobs by strengthening the position of our companies in world markets." *Id.* at C-4. Congress agreed, stressing the importance of providing tax incentives for U.S. firms to increase their exports not only because of their stimulative effect, but also to remove a disadvantage to U.S. businesses engaged in export activities through domestic subsidiaries:

> United States corporations engaging in export activities are taxed currently on their foreign earnings at the full U.S. corporate income tax rate regardless of whether those earnings are kept abroad or repatriated. In contrast, U.S. corporations which produce and sell abroad through foreign subsidiaries generally can postpone payment of U.S. tax on these foreign earnings so long as they are kept abroad.
>
> In addition, other major trading nations encourage foreign trade by domestic producers in one form or another. Where value added taxes or multistage sales taxes are used to any appreciable extent, the practice is to refund taxes paid by the exporter at the time of export and to impose these taxes on importers. In the case of income taxes as well, however, most of the major trading nations have features in their tax laws which tend to encourage exports. Both to provide an inducement for increasing exports and as a means of removing discrimination against those who export through U.S. corporations, [the House Ways and Means] committee's bill provides a deferral of tax where corporations meeting certain conditions—called Domestic International Sales Corporations—are used.

1971 House Report at 58; *see also* 1971 Senate Report at 90.

In enacting the DISC regime, Congress provided taxpayers with a broad incentive program. In order to maximize the benefit provided under the statute, Congress suspended several general rules of taxation that normally apply to taxpayers. Contrary to the treatment afforded other entities under the tax law, a DISC may be a corporation whose sole function is to serve as an accounting device for measuring the amount of export earnings subject to tax deferral. Treas. Reg. § 1.992-1(a). Congress also determined it desirable to avoid the complexities of the Internal Revenue Code's transfer pricing rules—which require a determination of an arm's-length price between related persons—and to adopt administrative rules for determining intercompany pricing. I.R.C. § 994. *See also* 1971 House Report at 73. These rules permitted the DISC to maximize its taxable income regardless of the sales price actually charged for the property. I.R.C. § 994(a).

The CTI method, used by Boeing in this case, is one of the two administrative pricing rules adopted by Congress in 1971. To further its intended effects, Congress created a statutory scheme that was clearly intended to permit DISCs to earn profits in excess of those earned under the arm's-length pricing rules otherwise used between related parties. 1971 House Report at 73-74; *see St. Jude Medical*, 34 F.3d at 1400. Thus, Congress established a unique regime under which taxpayers using DISCs were to obtain benefits not ordinarily then available.

III. TREAS. REG. § 1.861-8(e)(3) SHOULD NOT CONTROL THE CALCULATION OF CTI.

There are two primary reasons Treas. Reg. § 1.861-8(e)(3) should not govern the calculation of CTI. First, Congress intended only that the *general* principles of section 861 should apply in the DISC context. Second, the special allocation rule of Treas. Reg. § 1.861-8(e)(3) does not further those principles in this context.

A. Consistency with the Principles of Section 861 Does Not Lead to the Mechanical Application of the Special Allocation Rule in Treas. Reg. § 1.861-8(e)(3).

Computing CTI requires allocating costs to gross receipts and, in the first instance, requires allocating costs to the gross receipts to which they definitely relate. If costs are not definitely related to any receipts, they are apportioned on a ratable basis. Under Treas. Reg. § 1.994-1(c)(6)(iii), these allocations and apportionments are to be "determined in a manner consistent with the rules set forth in § 1.861-8." This regulation implements the legislative history providing that CTI should be determined "*generally in accordance with the principles applicable under section 861.*" The legislative history describes these principles, as follows: "These rules generally allocate to each item of gross income all expenses *directly related* thereto, and then apportion other expenses among all items of gross income on a ratable basis." 1971 House Report at 74; Senate Report at 107 (emphasis added). What is abundantly clear is that neither the regulation implementing the DISC provisions and governing the allocation of costs for CTI purposes nor the legislative history of the DISC provisions contemplates a mechanical application of rules later adopted under section 861 to the computation of CTI. These rules express respect for the principles of section 861, but they stop short of incorporating section 861 in its entirety into the DISC pricing rules. Treas. Reg. § 1.994-1(c)(6)(iii) contemplates "consistency." The legislative history contemplates applying generally the "principles" of section 861. In each case, the goal of the statute is to determine CTI based on definite relationships.

In defiance of this objective, the government insists that the mechanical rules of Treas. Reg. § 1.861-8(e)(3) be applied to allocate R&D expenses in determining CTI. This attempt at rigid application of rules crafted under section 861 for

another purpose is unsupportable and would cause distortion in the calculation of CTI. To understand this, a brief review of the background of the mechanical rules at issue may be helpful.

Section 861 of the Code contains the general sourcing rules for determining when income should be treated as earned within the United States. Coupled with sections 862 (source rules for income without the United States) and 863 (special rules for determining the source of income), these provisions "undertake to classify the sources of income within the United States by the nature and location of the activities of the taxpayer or his property which produces income." *Commissioner v. Ferro-Enamel Corp.*, 134 F.2d 564, 566 (6th Cir. 1943). Both sections 861(b) and 862(b) allow deductions for expenses, losses, and other deductions properly allocated and apportioned to the gross income items listed in sections 861(a) and 862(a), respectively, and allow deductions for a ratable part of expenses, losses, and other deductions not definitely allocable to some item of gross income.[7]

The sourcing rules have been a part of the tax law almost since the beginning of the modern income tax. The current statutory provisions trace their origins to the Revenue Act

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[7] In general, a taxpayer first determines aggregate gross income in accordance with section 61 and the relevant principles of the Code and then identifies its deductions. With respect to each deduction, the taxpayer must then identify ("allocate") the deduction with the category of gross income to which it relates. After deductions are allocated to a class, they are "apportioned" within that class between the statutory and the residual grouping of gross income. *See generally*, CYM H. LOWELL, G. MICHAEL TILTON, ANDREW W. SHELDRICK & MICHAEL J. DONOHUE, U.S. INTERNATIONAL TAXATION: AGREEMENTS, CHECKLISTS & COMMENTARY ¶ 7.03[2] (2002). If a deduction is related to all classes of gross income, it is generally allocated ratably. Treas. Reg. § 1.861-8(b)(5).

of 1921, Pub. L. No. 98, § 217, 42 Stat. 227 (1921).[8] The sourcing rules are important for a variety of reasons, but primarily relate to the computation of the foreign tax credit. A major policy premise underlying these rules is that the United States has the right to tax fully U.S.-source income but acknowledges the primary right of foreign countries to tax foreign-source income. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 100th Cong., 1st Sess. 916 (1987).

Treas. Reg. § 1.861-8 provides some general and some specific, mechanical guidance for allocating and apportioning deductions. From a general perspective, in matching an expense, loss, or other deduction with an income class, there must be a factual relationship between that item and the class of gross income. Treas. Reg. §§ 1.861-8(a)(2), -8(b)(2). In this regard, the rules state that classes of gross income are not predetermined. Treas. Reg. § 1.861-8(b)(1). This is entirely consistent with the DISC rule for determining CTI. If a deduction cannot be identified with any specific class of gross income, it will generally be allocable to all of the taxpayer's gross income. Treas. Reg. § 1.861-8(b)(5). Boeing's allocations were consistent with these general rules.

The DISC legislative history and regulations incorporate consistency with the general section 861 principles into the CTI calculation. That such consistency is contemplated, however, does not mean that the statute requires the mechanical application of Treas. Reg. § 1.861-8(e)(3). In other words, "consistent" means "compatible"; it does not mean "identical." *See Webster's Ninth New Collegiate Dictionary* 280 (1988). Indeed, it would be serendipitous if the rules crafted for determining income source could be

[8] The first statute requiring the allocation of deductions to income from specified sources was the Revenue Act of 1918, §§ 214(b), 234(b), Pub. L. No. 254, 40 Stat. 1057 (1918).

applied, without modification, to implement the DISC regime with equally important but different policy objectives.[9]

This Court has cautioned about the ill effects of mechanically applying the terms of rules structured for one purpose to the interpretation of another statute with a vastly different objective. In this regard, *Bowen v. Michigan Academy of Family Physicians*, 476 U.S. 667 (1986), is instructive. There, the Court considered a challenge by physicians to the validity of a regulation under Part B of Medicare, which authorized the payment of benefits in different amounts for similar services. The Medicare statute cross-referenced provisions of the Social Security Act that prohibited certain actions against the government.[10] The Secretary of Health and Human Services contended that the cross-reference demonstrated that Congress had forbidden judicial review of all questions affecting the payment of benefits under Part B of Medicare. The Court held, however, that the legislative history of the Medicare program provided specific evidence of Congress's intent to foreclose review only of "amount determinations," not of substantial statutory and constitutional challenges to the Secretary's administration of Part B. Thus, the incorporation by reference to the Social Security Act restrictions did not apply on its own terms to Part B, but rather was incorporated *mutatis mutandis*, *i.e.*, all

[9] As this Court has noted, "The policy as well as the letter of the law is a guide to decision." *Cox v. Roth*, 348 U.S. 207, 209 (1955) (citation omitted). In *Cox*, the Court refused to permit a literal application of the Federal Employers' Liability Act (FELA) to result in the denial of recovery under the Jones Act against a personal representative of the owners of a vessel lost at sea. The Court found that the exact words of FELA should not be "lifted bodily from their context and applied mechanically to the specific facts of maritime events." *Id.*

[10] Section 405(h) of title 42 provided that "no action . . . to recover any claim" arising under the Medicare laws shall be "brought under section 1331 . . . of title 28."

necessary changes having been made, into the Medicare statute. *Id.* at 679.[11] A similar logic should apply to this case.

In this case, the reference to the principles of section 861 in the DISC regulation and legislative history is not license to apply all the mechanical rules of the section 861 regulations for purposes of allocating costs, without regard to factual relationships, to sales in determining CTI. The objective of the statute—to allocate costs in accordance with some factual relationship—may not be arbitrarily foreclosed, as the government would do in this case.

B. Treas. Reg. § 1.861-8(e)(3) Is a Radical Departure from the General Rules and Principles of Section 861.

Under the general section 861 rules, a factual relationship between income and expense is a key element of allocation and apportionment. *See* Treas. Reg. §§ 1.861-8(a)-(d). These are the "principles applicable under section 861" to which Congress referred in 1971 and which the DISC statute contemplates will be applied in determining CTI—a factual connection between income and expense is clearly required. *See* I.R.C. § 994(a)(2) (requiring determination of net income "attributable to" the export sale).[12] When Treas. Reg.

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[11] In *Shalala v. Illinois Council on Long Term Care, Inc.*, 529 U.S. 1, 17-18 (2000), the Court clarified that the reasoning of *Michigan Academy* applied only when the statute precluded *any* review of a particular category of cases.

[12] The legislative history of the provision confirms that "[t]hese rules generally allocate to each item of gross income all expenses *directly related thereto*, and then apportion other expenses among all items of gross income on a ratable basis." 1971 House Report at 74 (emphasis added). CTI is determined by "deducting from the DISC's gross receipts the related person's cost of goods sold with respect to the property, the selling, overhead and administrative expenses of both the DISC and the related person which are *directly related to the production or sale of the export property.*" *Id.* (emphasis added). Thus, expenses related to property that is not exported are not allocated to export sales of other property.

§ 1.994-1(c)(6)(iii) was adopted in 1975, the mechanical rules on which the government relies in this case did not exist. Indeed, they were not adopted until a couple years later in 1977.[13]

In contrast, the special rules for allocating R&D expenses set forth in Treas. Reg. § 1.861-8(e)(3) are mechanical rules that apply *in lieu of the general section 861 principles* in allocating R&D expenses.[14] The government recognizes this in the regulation's first paragraph by confirming that the regulation is a substitute for the factual inquiry. Treas. Reg. § 1.861-8(e)(3)(i)(A) begins—

> The methods of allocation and apportionment of research and development set forth in this paragraph (e)(3) recognize that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and development.[15]

Rather than identifying a class of income to which the R&D expenditures actually relate, the regulation generally assigns

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[13] This regulation was later repromulgated in 1995 as Treas. Reg. § 1.861-17.

[14] The proposed section 861 regulations in place at the time the DISC regulations were issued retained the factual relationship principle in respect of R&D expenses and did not require the use of SIC codes. 38 Fed.Reg. 15840, 15843 (June 18, 1973).

[15] The regulations also specifically presuppose that the mechanical rules are not intended to effect an allocation of deductions to all gross income but rather address allocations to specific classes of gross income. *See* Treas. Reg. § 1.861-8(b)(1).

the expenditures to income related to a broad product category, which is limited to a list determined by two-digit SIC codes.[16]

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[16] It is difficult to see how a system that classifies economic data by industrial categories can also serve the purposes of matching gross income from the sale of specific products with the specific costs that are directly related to them. The SIC Code system was replaced by the North American Industry Classification System (NAICS) in 1997 because it was considered outmoded:

> The SIC was established to promote uniformity and comparability of data collected and published by agencies within the U.S. government, state agencies, trade associations, and research organizations. It was developed as an establishment-based industry classification system that classified each establishment (defined as a single physical location at which economic activity occurs) according to its primary activity. The SIC covered the entire field of economic activities by defining industries in accordance with the composition and structure of the economy.

U.S. Census Bureau, *Development of NAICS*, *reprinted at* http://www.census.gov/epcd/www/naicsdev.htm. The system was designed to "classify 'industry' in the broad sense of all economic activity; *i.e.*, agriculture, forestry, and fisheries; mining; construction; manufacturing; wholesale and retail trade; finance, insurance, and real estate; transportation, communication, electric, gas, and sanitary services; and services." Esther Pearce, *History of the Standard Industrial Classification* (Executive Office of the President, Bureau of the Budget, Office of Statistical Standards, July 10, 1957), *reprinted at* http://www.census.gov/epcd/www/sichist.htm.

Requiring the use of even three-digit SIC codes (as currently required by Treas. Reg. § 1.861-17) can produce absurd results. For example, R&D expenses directly related to main frame computers would be allocated to pencil sharpener receipts because both pencil sharpeners and computers are in the same three-digit SIC Code (357—Computer and Office Equipment). Examples of other product groupings include canned tuna fish and freeze-dried coffee (SIC Code 209), perfumes and floor wax (SIC Code 284), and batteries and extension cords (SIC Code 369).

The special allocation of R&D expenses may be appropriate in the context of the computation of the foreign tax credit, but it undermines congressional intent in respect of the computation of CTI. As the Eighth Circuit determined in *St. Jude Medical*, Treas. Reg. § 1.861-8(e)(3)'s requirement to use SIC categories in allocating R&D expenses "is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines." 34 F.3d at 1401 (citations omitted). "Doing so," the court stated, "may improperly decrease the profits allocated to a DISC, thus thwarting Congress's intent when it promulgated the DISC intercompany pricing rules." *Id.* at 1402-03. In effect, the government's proposed application of the mechanical rules of section 861 to the allocation of R&D expenses for DISC purposes would preclude any allocation to transactions or products based on actual factual relationships.

Although the government approach is consistent with the mechanical rules of Treas. Reg. § 1.861-8(e)(3), it is inconsistent with (i) section 994(a)(2)'s requirement for determining net income "attributable to" the export sale; (ii) the general rules of the section 861 regulations as they exist today, (iii) all aspects of those regulations as they existed at the time that Treas. Reg. § 1.994-1(c)(6)(iii) was promulgated, (iv) the mandate of Treas. Reg. § 1.994-1(c)(6)(iii) that requires allocations of deductions based on definite factual relationships, and (v) the flexibility afforded taxpayers to permit DISC benefits to be calculated by reference to CTI determined on a product-by-product basis after allocating costs based on factual relationships. Indeed, the consistency contemplated by the statute and Treas. Reg. § 1.994-1(c)(6)(iii) comes only by applying the general rules of the regulations under section 861 to establish definite factual relationships, not by departing from those relationships by applying the mechanical rules for allocating R&D expenses. This is particularly true where taxpayers, because of the structure of their sales and manufacturing

production and the detailed records kept, can clearly establish the necessary factual relationships. In contrast to Treas. Reg. § 1.861-8(e)(3), the section 994 regulations are consistent with congressional intent because they permit taxpayers to allocate R&D costs to products and product groupings based on factual relationships.

It is enlightening that neither the Ninth Circuit nor the government seeks to justify the application of the mechanical R&D rule to allocations under section 994 on the ground that it achieved allocations based on factual relationships. Indeed, the Ninth Circuit seeks to justify the application of a rule that ignores factual relationships on the grounds that the deductions at issue might be considered unrelated to specific income items. *See* App. at 12a. But this analysis does not support the application of the rule at issue since that rule is not one that purports to allocate deductions ratably.[17]

It is consistent with "the principles applicable under the section 861" for the allocation of R&D expenses to yield to the DISC and FSC rules. *Cf. Rite Aid Corp. v. United States*,

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[17] That Boeing's R&D expenditures may have exceeded its income in a given product category in any year is irrelevant. The section 861 regulations clearly contemplate situations in which the costs directly related to a particular product line will exceed the gross income generated by that product line in a particular year. Treas. Reg. § 1.861-8(d)(1) specifically states that "[e]ach deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section [dealing with the 'factual relationship between the deduction and a class of gross income'] even though, for the taxable year, *no gross income in such class is received*" (emphasis added). The specific regulation relied upon by the government for the allocation of R&D expenses also provides that "[a]mounts apportioned under this paragraph (e)(3) may exceed the amount of gross income related to the product category within the statutory grouping." Treas. Reg. § 1.861-8(e)(3)(ii)(B). This is consistent with the current deductibility of R&D expenses and the result of the annual accounting for taxes.

255 F.3d 1357, 1359-60 (Fed. Cir. 2001) (holding that a consolidated return regulation cannot be used to subvert the intent of another statute); *see also United Dominion Industries, Inc. v. United States*, 532 U.S. 822, 839 (2001) (Thomas, J. concurring) (when construing a complex statutory and regulatory scheme that lends itself to several interpretations, "we should be inclined to rely on the traditional canon that construes revenue-raising laws against their drafter."). By mandating the use of a special allocation rule for R&D expenses in respect of DISCs and FSCs, the government does violence to those statutory schemes. The Eighth Circuit in *St. Jude Medical* is correct: Treas. Reg. § 1.861-8(e)(3) is invalid as applied to the computation of CTI.

CONCLUSION

For the foregoing reasons, the Court should reverse the decision of the U.S. Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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